New Europe Economic Dossier aims to provide a structural view on the evolution of the various countries in the region, highlighting the main achievements and the open challenges. Each issue is dedicated to a specific country and includes an analysis of the economic situation plus an interview to a leading figure for the future of the country. The dossier is edited by the New Europe Research Network of UniCredit.

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Turkey, at the starting point in the Great Transformation

After prolonged discussions between EU and Turkey, as well as within the EU, Turkey's accession negotiations started on October the 3rd. This is yet another turning point in the recent economic and political history of Turkey. The first important milestone was the trade liberalization in 1980, followed by the capital account liberalization that was effective as of 1989, a leap forward that proved to be at least as significant as the one in 1980. And finally the EU saga which effectively started to come to life with the signing of the customs union in 1995, but then dragged on for almost a decade with hardly any progress until the Helsinki summit in 1999.

It should be noted that the EU-Turkey relations have a history of more than 40 years, but the acceleration of these relations, or at least their move to the top of Turkey's (as well as EU's) agenda is quite recent. It has been a bumpy road for both sides to say the least, and will continue to be so for the duration of accession talks. To understand the dynamics between the EU and Turkey, it is necessary to briefly trace the path since Turkey's association in 1963. In May 1967, based on the Ankara Agreement of 1963, Turkey asked for the transition to a Customs Union to begin. After long and drawn-out negotiations, the 1970 Additional Protocol was signed, providing for a 22-year transitional period that would end in a customs union as specified in the Association Agreement. From the 1970s onwards, an estrangement in relations became apparent, particularly after the Additional Protocol entered into force in 1973. Together with global economic backdrops and political instability in Turkey, the Association faced some problems. Finally, the Association experienced a five-year halt after the military coup in 1980. The Association was reactivated in 1986, and in April 1987, the Turkish Government submitted an application for accession. The European Commission's opinion, which was given two years later and was endorsed by the European Council, deferred the application in the short and medium term. As an "alternative", it suggested a focus on the Customs Union as foreseen in the Ankara Agreement and a revitalization of the Association. The acceptance and ratification of the Customs Union in 1995 (coincidentally, on time) happened only after many debates but marked a major watershed in Turkish–EU relations since 1963. At one point considered "the most traumatic element of EEC membership for Turkey", the Customs Union has continued to be an integral part of the Turkey–EU relationship. Nonetheless, relations hit rock bottom again when the Luxembourg European Council in December 1997 refused Turkey's candidacy while opening the door for the Central and Eastern European candidates. Upon this decision, Turkey broke off its political dialogue with the EU. Finally, the Helsinki Council in 1999 reversed the Luxembourg decision by formally recognizing Turkey's candidacy.

Supporting Turkey in its reform process, the European Council announced in December 2002 that if Turkey met its political "Copenhagen" criteria by the end of 2004, it would open negotiations without delay. As part of the candidacy process, the EU Council formally adopted Accession Partnerships with Turkey on 8th March 2001, and an updated version in May 2003. They are essentially a roadmap of the priorities for Turkey in making progress towards meeting all the criteria for accession to the EU. Finally, based on the European Commission's recommendation, the European Council decided to start Turkey's membership negotiations in 2005, October the 3rd. In short, the EU-Turkey relations are older and more deeply rooted than commonly assumed. Hence the start of negotiations should not be seen as an unexpected and strange move of the European elites.

For the new 10 members of the EU, negotiations lasted for less than 5 years. In the case of Turkey, negotiations can last up to 10 years. However, according to the 13th article of the negotiation framework, negotiations can be concluded after the establishment of the Financial Framework for the period from 2014 onwards. Possible consequences of financial reforms must also be considered.

Overall, the Turkish government seems to be fully committed to the EU project. This political pref-

MACROECONOMIC DATA AND FORECASTS

	2003	2004	2005f	2006f	2007f
Nominal GDP (bln YTL)	359,8	430,5	490,9	547,4	606,8
Real GDP yoy %	5,8	8,9	5,1	4,7	5,3
Inflation (CPI) yoy, avg	25,3	10,6	8,0	6,9	4,8
Unemployment rate %	10,5	10,3	9,5	9,0	8,5
Exchange rate /euro, avg	1,6936	1,7765	1,7000	1,7521	1,8201
Interbank rate O/N simple eop, %	26,00	18,00	13,50	12,25	10,50
Current Account/GDP %	-3,3	-5,1	-6,1	-6,5	-5,3
FDI/GDP %	0,0	0,5	1,2	1,6	2,0
Budget Balance/GDP %	-11,1	-7,0	-4,5	-3,0	-3,0
Primary Balance/GDP %	5,2	6,1	5,1	5,0	5,0
Public Debt/GDP %	82,7	77,1	71,3	67,5	62,0

Sources: The Central Bank, State Institute of Statistics, Koc Yatirim Research Division, UniCredit New Europe Network

erence is largely shared by the Turkish public as well. Although it has declined somewhat recently, support for Turkey's EU membership among the general public is still at 59%. This means the EU-related reforms are welcomed by the public, in spite of some heated discussions in different spheres regarding a wide range of topics, from the "double standards being applied to Turkey by the Union" to "conspiracy theories that claim a resolution on the part of the EU to rid Turkey of her sovereignty". Nevertheless, widespread public support strengthens the Turkish government ahead of the negotiation process.

Candidacy progress naturally brought forth considerable economic payoffs. Acceleration of the EU process led to an improvement in Turkey's "unofficial" rating, unofficial as the rating agencies' ratings remained largely the same. This is very much visible in foreign investors' increasing appetite for Turkey, both in the form of portfolio investments and Foreign Direct Investment flows (FDI). Privatizations and FDI flows recorded record high levels in 2005, and further progress is expected in 2006 and beyond.

For the last three years, Turkey has been enjoying a high growth/low inflation environment, and this has been the main catalyst for increased foreign interest in the country, which was naturally complemented by the EU process. Following the economic contraction of 7.5% in 2001, 2002-04 period witnessed a cumulative growth of 24.3%. The producer price inflation declined from 88.6% yoy in 2001 to 2.57% as of October 2005. Similarly the budget deficit/GDP ratio declined from 16.0% in 2001 to 7.0% in 2004, and the 2006 figure is likely to decline to 3.0%. Among all these improving fundamental indicators, the only unfavorable move was seen in external accounts, which is a source of concern. Notwithstanding the increasing demand for imported intermediate goods in quantity terms, an important aspect of the worsening trade deficit is the rise in commodity prices. Oil imports can be given as an example: the average barrel price of oil increased by 47% in the first nine months of 2005 compared to the same period of 2004 and by 85% compared to 2003. The dollar value of oil imports displayed a similar upward move. This alone explains roughly USD 5.0 billion of the deterioration in the current account in 2005.

The financing quality improved considerably in the recent years and this improvement gained momentum with the acceleration of the EU process. The first and perhaps most important improvement is seen in FDI flows which recorded an historical peak with USD 2.9 billion in the first eight months of 2005. As a compact item of financing, we can look at the sum of FDI, equity sales and Net Errors and Omissions (NEO), which constitute forms of financing without increasing net indebtedness. That sum has gone up from USD 1.87 billion in 2004 to USD 11.04 billion in 2005. Granted, the increase in Net Errors and Omissions is a crucial portion of that surge, but other items also displayed significant increases and, going forward, increases in those should dominate any movement in NEO. Moreover, it is likely that rising NEO reflect, at least in part, a shift by domestic residents from foreign currency denominated assets to YTL-denominated assets. This is precisely what we find extremely promising regarding the financing of current account deficits in Turkey, and the EU process in the aftermath of the October 3rd decision should be acting as a significant buffer in case of any untoward surprise.